### A. A Rule Specifying Risk Surrogates for the Interstate Access Services of Exchange Carriers is Not Necessary.

The Commission asks for comment on the potential risk surrogates for rate of return regulated exchange carriers' interstate exchange access services.[77] It identifies three potential risk surrogates from the universe of alternatives: the Regional Bell Holding Companies (RHCs), the Standard & Poor's (S&P) 400, and the 100 large electric companies.[78]

No single option stands out as a conclusive surrogate. No single surrogate will consistently prove appropriate. Narrowly based indicators can be dictated by nonsystematic or ideosyncratic anomalies. Broadly based indicators avoid those distortions. The S&P 400 has the most merit of the options proposed, if it is qualified and done properly.[79]

The other stated options are inadequate. As the Commission recognized in 1990, the RHCs, in contrast to their telephone operating company subsidiaries, are increasingly diversified, and these diversified entities are not fully comparable to exchange carriers or each other.[80] The Commission itself recognizes that electric companies' businesses are not comparable to the activities

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[77] Notice at ¶ 50.

[78] Notice at ¶ 50.

[79] In the Notice, the Commission identifies a "100 electrics" group, but there is no such widely recognized group in financial analysis for exchange carriers.

[80] Notice at ¶ 50, citing 1990 Represcription Order, 5 FCC Rcd 7507, 7517.

of rate of return regulated exchange carriers in today's "dramatically changed" telecommunications environment.[81] The business risk of electric companies is not comparable to the business risk of exchange carriers. Exchange carriers face significantly greater business risk.

USTA does not support codification of any single surrogate. Rather, an opportunity for variation is appropriate. Part 65 should allow any option that is justified to be used, with the Commission addressing the weight it is to be given in the context of its represcription analysis and order. The Commission should be receptive to the use of any approaches that will identify firms of comparable risk. Part 65 should allow the selection of firms that are of comparable risk from a broadbased universe of companies.

The Commission seeks comment as to whether there should be a specific risk surrogate for rate of return exchange carriers.[82] The Commission doesn't need a specific new risk surrogate for rate of return exchange carriers. It appears that the risks of interstate access for small exchange carriers are comparable to the risks of interstate access for large carriers. The Commission so concluded in the docket that produced Part 65.[83] Today, that

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[81] Notice at ¶ 50.

[82] Notice at ¶ 50.

[83] 84-800 Supplemental Notice, at ¶ 34 ("a unitary rate of return is warranted because all exchange carriers face the same risks in providing access." The Commission stated that interstate service is subject to the same regulator, and sold to the same interexchange carrier customers through a similar system of access charges.)

remains true. Each exchange carrier faces extensive competitive risk in the form of interexchange carrier direct connection, large business bypass, wireless alternatives and other options. Each faces the prospect of technological obsolescence and the inability to generate capital recovery at the pace required by rapid industry change. Each faces adversaries seeking to deny them the opportunities needed to make their access services fully competitive. Investors who have an interest in telecommunications see a comparable core risk for the interstate access services provided by exchange carriers.[84]

The Commission wisely proposes to repeal section 65.400 of the Part 65 rules, though USTA is concerned that the Commission is doing the right thing for the wrong reason.[85] The repeal of section 65.400 is appropriate, but only if the Commission continues to allow the use of the options that are accommodated in that section now, such as options within the family of comparable firms methods known as cluster analysis. A cluster analysis was a part of USTA's submissions in both 1989 and 1990, and is a widely used methodology in the comparable firms area.[86] The Commission should not prevent its use because it disagreed with the result.

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[84] This further underlines the merit in a unitary rate of return.

[85] Notice at ¶ 53.

[86] While the original proposal in the Refinement of Methodologies Proceeding would have accommodated a cluster analysis, there were limitations. The cluster analysis filed in the 1990 Represcription Proceeding was different from that contemplated in 1987. A cluster analysis filed today could be different still.

The Commission also would omit from any consideration in the future other options now covered by section 65.400, such as screening and spanning. Spanning is currently a fertile area of research that may gain strong favor in the future. Again, to reject any emerging methodologies would be contrary to the public interest.

### B. The Commission's Cost of Equity Discussion Has Serious Flaws.

The need for simplification is perhaps nowhere so evident as in estimating cost of equity for exchange carrier interstate access service. While the Commission has proposed methodologies that would be "presumptive" or "conclusive" with regard to capital structure and cost of debt, it has recognized the different nature of estimating cost of equity in stating: "(w)ith regard to the cost of equity determination, we propose to retain our policy of determining the weight to be accorded any particular methodology at the point we represcribe the authorized interstate rate of return."[87]

Although, as shown in the sections below, USTA makes recommendations for some simplification of cost of debt and capital structure, estimating cost of equity is decidedly more complicated, and thus less amenable to simplification. With equity, unlike debt, there are no contractual cash flows that can be related to the market price of an equity security. As the Notice shows, virtually every element of every methodology used in this area

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[87] Notice at ¶ 47.

requires judgment, and in the past has been subject to dispute over its measurement.

### 1. Estimating the Cost of Equity - Generally.

USTA's view of estimating cost of equity is, essentially, quite simple. The Commission references two general approaches to measuring the cost of equity, the discounted cash flow (DCF) and the risk premium methods. USTA does not disagree with some consideration of these approaches, but the Commission should not limit its rules to specific implementations of these approaches alone as the Notice anticipates. Nor should it assign a particular weight to any single approach in its rules.

The Notice asks for consideration solely of the so-called "classic" DCF.[88] This is often described in the literature as the constant-growth variant. The Notice also seeks comment on several risk premium methods.[89] Although these methods are discussed below, USTA recommends a simpler approach with regard to cost of equity estimation.

The DCF approach, when properly implemented, can be useful. The same is true with risk premium methods. These are the two general "families" of methods for estimating cost of equity, tried and sometimes true for the past several decades. However, by

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[88] Notice at ¶ 60. While characterized as "classic," it is not the commonly accepted DCF method. The prevailing DCF model is one that uses full "g" rather than 1/2 "g" in the formula.

[89] Notice at ¶ 74.

codifying any one DCF method or any one risk premium method, for example, it may be viewed as an endorsement of this method as the one best yielding the "truth" about the cost of equity. Yet, no one can know with any degree of certainty that at any given time a single method or variant will always yield accurate, much less the most accurate, results. Given the nature and difficulty of measuring cost of equity, it would be prudent for the Commission to permit an analyst to use any relevant tool to determine a range of estimates. The analyst determines which methods best suit the exercise on the basis of the circumstances extant at the time. Not only must changing circumstances be considered, but the evolving nature of the study of finance may play an important role in determining which methods to use. Investors and the investment community will always be taking current circumstances and current theory into account when determining their required returns on equity. It is, therefore, in the public interest that the Commission allow those participating in represcription proceedings to do the same.

Consequently, the Commission should avoid the problems inherent in specifying any one cost of equity method or group of methods. Parties cannot agree on the exact specification of a method because circumstances and the state of theory are dynamic. For example, the exchange carriers in their pleadings in the 1990 Represcription Proceeding strongly objected to the use of a constant-growth DCF on the RHCs.[90] Yet, nowhere in the record did

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[90] See pleadings referenced in the Order, 1990 Represcription Proceeding, 5 FCC Rcd 7507 at ¶¶ 77-79.

the exchange carriers or USTA contend that the constant-growth DCF would never provide useful information. It simply cannot operate as a per se rule, or be established as the sole measure of cost of equity. USTA does not endorse any specific risk premium method for the same reasons. There is no guarantee that what may prove most reasonable today will do so at any point in the future.

The Commission notes the difficulties in the Part 65 rules' specification of formulaic-based estimates to be produced in the record.[91] That experience, finding that codification of then-preferred methods later prevents productive analysis, indicates why the Commission should avoid just such a recommendation at this time.

Therefore, USTA recommends that the Commission recognize that, for the reasons stated above, it is best **not** to codify a specific cost of equity method or methods into the rules. Instead, the Commission should recognize that there may be any number of ways to estimate cost of equity, depending on then-current circumstances. Permitting the use of all methods available at the time will provide a range of estimates of the cost of equity rather than a point estimate. Having a range of estimates available reduces the chance of error, and thus is preferable to reliance on only one or two prescribed methods. A range can provide a measure of confidence that the result will be reasonable.

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[91] Notice at ¶¶s 55-56.

Even within the DCF and risk premium categories, interested parties should be able to choose the methods that best suit the circumstances. However, parties should not be limited to these two approaches. Currently, the investment community is making use of estimates derived from a risk premium approach known as the arbitrage pricing theory (APT). While APT is still relatively unknown in the regulatory arena, it is discussed in almost all intermediate finance textbooks and a significant body of literature is available beginning in the mid-1970s. Likewise, a spanning approach to developing risk surrogates has been widely discussed.[92] New approaches emerge and displace methods that may have been in place for decades. It would be a mistake to codify any approach.

USTA supports the Commission's proposal to delete historical DCF formulas from the rules.[93] This is consistent with USTA's general recommendation that no specific cost of equity methodologies should be codified. By its own admission, the Commission's historical DCF approach was clearly demonstrated not to have provided useful information in the last represcription.[94]

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[92] See, e.g., The Linkage Between Risky Cash Flows and Asset Returns, Mark K. Krueger and Charles M. Linke, Office of Public Utility Research Paper 91-008 (Univ. of Illinois at Urbana-Champaign, October, 1991).

[93] Notice at ¶ 56.

[94] Notice at ¶ 55.

The Commission refers to the constant-growth form of the DCF as the "classic" DCF formula and noted that it gave this approach the greatest weight in the 1990 represcription.[95] The "classic" DCF formula is a simplification of the general form of the DCF and is based on a number of simplifying assumptions which may or may not be realistic in the real world. USTA rejected its use on the RHCs in that proceeding because of a mismatch in key variables, that is, in stock price and expected growth, among other infirmities. This does not preclude some use in the future given its application to the correct universe of companies.

### 2. Other Areas Where Specific Comment Was Requested.

The Commission requests comments on the use of a "zone of reasonableness" to provide a range of values in future represcriptions.[96] USTA's recommendation that the Commission encourage participants to utilize all available methods and all data at their disposal to establish a zone of reasonableness is generally in concert with the Commission's desire for a reasonableness check. USTA disagrees with the use of a check formulaically derived from a constant-growth DCF estimate for the S&P 400, although a constant growth DCF applied to the S&P 400 can provide useful information. Again, the Commission assumes that this approach has been and will continue to be the best measure. This assumption cannot be made.

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[95] Notice at ¶ 57.

[96] Notice at ¶ 60.

The Commission's analysis in Exhibit A to the Notice covers the period 1984-1990. The Commission states that the RHCs' DCF cost of equity comported with S&P 400 data between 1984 and 1987 but that an upward adjustment has been necessary since then.[97] Thus, for fully one-half of the period covered by Exhibit A, a discrete judgmental adjustment was found to be needed to bring the estimates in line. This comparison also implies that both the constant-growth DCF estimates for the S&P 400 companies and for the RHCs are correct. Yet, the use of an adjustment indicates this assumption is faulty. While estimates based on some broad universe of companies, such as the S&P 400, provide useful information, it is risky to specify in any rule precisely how to derive those estimates, or what the relationship is between the exchange carriers and the S&P 400.

The Commission has asked for comment on the specific components in the constant-growth DCF formula.[98] The complexity and risk of codifying a specific methodology into the rules are most apparent here. Even so simplified a formula as this version of the DCF can be rendered complex and contentious because of the inputs. The need to avoid codification in cost of equity estimation should be apparent in this section. Although it is opposed to writing this kind of detail into the rules, USTA will comment on the concerns raised by the Commission.

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[97] Notice at ¶ 59.

[98] Notice at ¶¶s 60-67.

The use of average stock prices can help to limit bias resulting from unusual price movement. With today's computer capabilities and financial data bases, it is possible to incorporate more data points into an average figure. An average of daily highs and lows could be a useful tool.

The Commission already has expressed its preference that current dividends be increased by one-half the IBES growth estimate (g) in the DCF computation.[99] It does so again here.[100] The constant-growth DCF formula itself is derived from a mathematical simplification of the general form of the DCF that relies on $D_1 = D_0(1 + g)$, instead of one-half g.[101]

Specifying reliance on IBES growth estimates precludes the use of other currently available data such as Zack's consensus or First Call consensus growth estimates. It also assumes the continued existence and reliability of IBES data. Given these considerations, it would be risky to codify this one source for the estimate of g alone.

A key argument given by the Commission against quarterly compounding is "increased complexity."[102] However, current

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[99] Order, 1990 Represcription Proceeding, 5 FCC Rcd 7507 (1990).

[100] Notice at ¶ 63.

[101] See App. 3A, Intermediate Financial Management, Brigham and Gapenski, 3d Ed. (1990) for the mathematical derivation.

[102] Notice at ¶¶s 64-65.

technology, new tools and basic financial theory rebut that claimed justification. Current computing power and spreadsheet software can handle the rather straightforward formula used in quarterly compounding. Companies actually pay dividends quarterly, and any model used can and should reflect this reality.

The Commission discusses the need for a flotation cost adjustment.[103] In reviewing the previous record, it assumes incorrectly that participants cannot make a showing for flotation costs. As USTA and others stated in the 1990 represcription, the need for recovery of equity flotation costs is not permanently obviated just because out-of-pocket costs are not separately recorded in the issuance of equity or because an allowance was once granted.[104]

The Commission seeks comment on the risk premium method.[105] It invites comment on risk premium methods in general as well as a specific form of risk premium method, the capital asset pricing model (CAPM). Here, the Commission's concerns over actual implementation of risk premium methods are well founded. USTA shares its concern that reasonable people may disagree not only over the method in general but about each and every component element incorporated in that formula. It is just these

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[103] Notice at ¶¶s 66-67.

[104] Order, 1990 Represcription Proceeding, 5 FCC Rcd 7507, at ¶¶ 73-74. These arguments added to those presented in the 84-800 Phase II Proceeding.

[105] Notice at ¶¶s 68-75.

disagreements alluded to by the Commission that make codification of any one or several risk premium methods inadvisable. The stated concerns are considered in turn.

USTA is encouraged that the Commission recognizes the potential of the risk premium approach for estimating cost of equity.[106] The Commission's concern over estimates of risk premiums and betas is understandable. While these methods are all designed to estimate the cost of equity on a going-forward basis, most rely on historical data. Though steps can be taken to mitigate these problems (some are discussed below), no one knows with certainty that any one adjustment will be correct. Consequently, it is not advisable to say which risk premium approach is most correct, and even more risky to incorporate one view into the Part 65 rules.

The Commission is correct in recognizing that risk premiums derived from historical data are dependent on the sample period chosen.[107] Arguments can be made that, given a long enough sample period, all future possibilities will likely have been incorporated in the historical span being considered. In contrast, use of a short span of time runs the risk of specific events skewing the data. This issue is far from being resolved. Specifying a specific time period into the rules would falsely imply just such a resolution.

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[106] Notice at ¶ 71.

[107] Notice at ¶ 72.

The Commission-implied RHC-specific risk premiums described in the Notice rest on two assumptions.[108] The first is that for the risk premium to be correct, the implied cost of equity used in prior Commission orders must be correct. The second assumption is that the seven observations dating from 1967 that are relied on by the Commission in Exhibit C are representative of all future potential risks. The first assumption contains an inherent circularity; that is, the Commission-ordered cost of equity must first accurately reflect the cost of equity for the companies for which it is prescribing rates. Certain assumptions must be made that the cost of equity ordered is accurate in the first place. The second assumption is highly debatable, and in USTA's view, bound to prove inaccurate, given the changes occurring in the industry. A better option is to leave the development of risk premium data to participants in a proceeding.

The Commission has estimated risk premiums for a large segment of the market (using S&P 400 companies) based on investor expectations, as derived from the constant-growth DCF, rather than based on historically achieved returns.[109] While an approach such as this can have merit, incorporating it into the rules is unduly restrictive. It would require agreement over what method and what inputs to use in estimating the cost of equity for the market, which market universe of companies to use, and which bond yield is

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[108] Notice at ¶ 73.

[109] Notice at ¶ 74.

most appropriate. Again, for the reasons set out above, USTA recommends no codification of any one approach.

Likewise, the Commission's rejection of the five CAPM analyses presented in the 1990 Represcription Proceeding illustrates the danger of codifying any one method. The five analyses cited were all variants of a single approach, using historical risk premiums. Yet, earlier, in CC Docket No. 84-800, Phase II, other approaches were proposed that were not discussed in this Notice, and the Commission recognized merit in them.[110]

However, USTA supports the Commission's option that data permitting a preferred risk premium analysis be included in the record in future proceedings.[111] The actual choice of method and implementation is best left to participants to evaluate under the then-current circumstances.

### C. Calculating Capital Structure and the Cost of Debt.

#### 1. Capital Structure.

Capital structure, along with the costs of debt and preferred stock, are areas where simplification can produce benefits. The Commission invites comment as to a number of options.[112] As an effective simplification method, USTA advocates the use of readily

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[110] Order on Reconsideration, 84-800 Phase II Proceeding, 104 FCC 2d 1404 1439 (1986). The Commission declined to endorse the approach at that time because five years of postdivestiture data were not available.

[111] Notice at ¶ 75.

[112] Notice at ¶¶s 83-85.

available Form M data to determine capital structure and embedded cost rates. This will provide a dependably accurate result while introducing substantial simplification over the methods most recently used.

The most appropriate capital structure for determining a unitary rate of return is a composite capital structure of the BOCs. The Commission's use of RHC capital structures should be discontinued. The use of RHC or other holding company consolidated capital structures is inappropriate because it would capture the financial risk inherent in all holding company operations, including significant operations other than interstate access services, rather than the relevant financial risk inherent in exchange carrier operations. Holding company operations that are non-exchange carrier in nature can have entirely different financial risk characteristics. The proportion of such diversified holding company operations is significant and growing in number, for both the RHCs and for the other holding companies of exchange carriers with annual revenues of $100 million or more (Tier I LECs).

For example, 1991 revenue distribution data from the S&P Telecommunications Compustat data base indicates that at least eight of the holding companies of Tier I LECs derive over 20% of total revenues from non-exchange carrier operations. The proportion of 1991 revenues derived from non-exchange carrier operations ranged as high as 23% among the RHCs and 68% among the holding companies of Tier I LECs. The proportion of December 31,

1991 assets devoted to non-exchange carrier operations ranged as high as 28% among the RHCs and 51% among holding companies of Tier I LECs. Clearly, the sustained holding company movement into diversification demonstrates that the holding companies that own exchange carriers are not good surrogates for the exchange carriers themselves. Capital structures of holding companies that own exchange carriers are no longer appropriate for determining a unitary rate of return for exchange carriers. A continued focus on holding company capital structures would inappropriately ignore the unique risks of exchange carriers.

The preferable capital structure approach is to use an actual BOC composite capital structure based on Form M data. This can be targeted carefully and precisely toward the information desired. Exchange carriers, whether BOCs or Tier I LECs, are separate legal and financial entities with capital structures that are separate and distinct from affiliated non-exchange carrier operations. The exchange carriers' interstate rate bases are directly supported by their actual capital structures. Current exchange carrier actual capital structures are within traditionally accepted limits, according to any standard of comparison. Exchange carrier actual capital structures reflect the business risks faced by exchange carriers. As business risk has increased in the exchange carrier industry due to the competitive and other forces that this Commission has acknowledged, and indeed, promoted, higher equity ratios are required, decreasing financial risk to partially offset the higher business risk.

Given current business risk levels, the S&P financial benchmarks indicate the equity ratios that are appropriate to maintain certain bond ratings.[113] For example, the current exchange carrier guideline for an "AA" bond rating is an equity ratio of at least 58%, while the guideline range for an "A" rating extends as high as 60%. In general, the BOCs and the Tier I LECs have AA or A bond ratings.

The Commission's use of a "conclusive" capital structure with an equity ratio that is less than the actual equity ratio could cause the entire exchange carrier industry to be downgraded by the investment community. It would increase the overall cost of debt and the overall cost of capital. In addition, it could deny exchange carriers the ability to earn a reasonable return on prudently invested capital.[114]

USTA continues to disagree with the view expressed in the Notice that there is a possibility that capital structures would be manipulated.[115] In today's regulatory environment, no incentive for manipulation of exchange carrier capital structures can exist because no covert benefit can be sustained. Nor has any evidence of capital structure manipulation been offered by any party in any rate of return prescription docket before the Commission. The

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[113] S&P Creditweek, February 10, 1992 at 5.

[114] Illinois Bell v. FCC, 911 F.2d 776 (D.C. Cir. 1990); Jersey Central Power & Light Co. v. FERC, 810 F.2d 1168 (D.C. Cir. 1987).

[115] Notice at ¶ 84.

Commission relied on fear and not fact in addressing this issue in 1990.

Exchange carrier capital structures are scrutinized by state regulatory commissions who typically are quick to investigate any alleged manipulation. Furthermore, all Tier I LECs have issued debt that is held by independent investors, who monitor and assess the exchange carriers' capital structures. Carriers explain or justify financial actions of this kind with credit rating agencies. It is inappropriate for the Commission to base a key capital structure decision on mere speculation of possible manipulation, with no demonstration or quantification in fact.

A composite actual capital structure of either the BOCs or Tier I LECs could be representative of the exchange carrier industry. On balance, and assuming that a similar approach is used for the cost of debt, USTA supports the use of the composite capital structure of the BOCs rather than the Tier I LECs.

All BOCs are Tier I LECs, but there are approximately 32 other, non-BOC Tier I LECs as well. While the inclusion of these non-BOC Tier I LECs is not conceptually flawed, USTA believes that such inclusion would not significantly alter the resulting composite capital structure in any material way, and, using anything approaching the current methods, would create burdensome new requirements for the 32 non-BOC Tier I LECs. Thus, the cost of this alternative would significantly outweigh any benefit.

The capital structure resulting from the inclusion of non-BOC Tier I LECs would be similar to the BOC capital structure for two reasons. First, most of the non-BOC Tier I LECs and BOCs are financed similarly, with virtually indistinguishable capital structure ratios and costs of debt. Secondly, on a composite basis, the total capital of all BOCs represents approximately 81% of the total capital of all Tier I exchange carriers. The inclusion of the non-BOC Tier I LECs that represent only the remaining 19% would not significantly alter the composite capital structure. As a result, there is no need to include non-BOC Tier I LECs in the composite. USTA stipulates to the practical equivalence of the two composites.

In contrast, requiring the inclusion of non-BOC Tier I LECs' debt would require over 30 additional companies to compile voluminous debt information on an issue-by-issue basis in a unique format not normally used by the carriers. This would not be a source of Part 65 simplification for these companies, and this burden would likely outweigh all other simplification here.

Even if the Commission should adopt the simplified Form M approach USTA proposes below, the inclusion of non-BOC Tier I LECs also would create a significant burden for the Commission. Over 30 additional Form M reports would have to be included in the new composite, and reviewed during any represcription. As a result, the inclusion of non-BOC Tier I LECs fails a simple cost-benefit test. It provides little additional accuracy or comfort to the Commission, and it imposes significant additional burdens. The

Commission should not use that Tier I LEC measure for capital structure.

The use of a composite capital structure of a "representative sample" of remaining rate of return exchange carriers also would be an inferior option. USTA is unable to identify any single group of criteria that would produce such a "representative sample." The remaining rate of return exchange carriers have diverse capital structures. The Commission has previously acknowledged this in CC Docket No. 84-800.[116] The necessary sample size would likely have to be so large that this option would be impractical to implement. USTA has not been afforded the opportunity to review the Commission's preliminary analysis of this option, so it cannot directly comment on that analysis.[117]

The use of any specific capital structure that would be "conclusive" is also inappropriate, because the appropriate capital structure for the composite will always be changing.[118] Business risk and capital market conditions change, thus requiring corresponding capital structure changes over time. The actual capital structure will reflect this evolution over time, but any "conclusive" capital structure cannot. The use of a "conclusive" capital structure actually could reduce investment in exchange carrier networks by limiting the equity investment on which an

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[116] 84-800 Supplemental Notice at ¶ 37.

[117] See Notice at ¶ 85.

[118] Notice at ¶ 86.

exchange carrier can earn an appropriate return. Reducing investment would penalize all customers who rely on those networks.

Short-term debt can be included in total debt along with long-term debt. Preferred stock is minimal in most exchange carrier capital structures, but if it exists, should be included as a capital structure component. Preferred stock is a separate financial instrument, and is an investor-supplied source of capital with its own embedded cost. Currently, no BOCs have outstanding preferred stock. However, there are some non-BOC Tier I LECs with outstanding preferred stock. In most instances, the preferred stock proportion is relatively small. Thus, the need to include preferred stock at all will depend on the group of composite exchange carriers selected. Under USTA's proposal to use BOC Form M data, preferred stock is not currently relevant.

Finally, the Commission asked about the treatment of various "zero-cost" items.[119] The Commission should continue to exclude non-investor supplied, rate base-subtracted and zero-cost components from the capital structure.

As USTA has previously advocated, Form M reports should be used as the data source to determine the composite capital structure of the BOCs or, in the alternative, of all Tier I LECs. Exchange carriers need not be required to submit extensive information on a burdensome issue-by-issue basis. Form M reports

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[119] Notice at ¶ 87.

are already readily available, since reporting exchange carriers are required to submit Form M reports to the Commission annually, and it is the Commission that specifies the form of those reports.

The Form M approach proposed by USTA is straightforward. It requires the use of the following Form M data for debt: Schedule B-1, Rows 420, 1407, 4020, 4050 and 4060; and for Common Equity and Preferred Stock: Schedule B-1, Row 440 and Schedule B-14. The average capital structure components of debt, preferred stock, and common equity are determined by averaging the beginning and ending balances of the following items:

Preferred Stock: Sum of the "total" column of the "preferred stock" rows (less any corresponding amounts for Treasury stock) on Schedule B-14;

Common Equity: Difference between Row 440 (Total Stockholders Equity) and the preferred stock amount from Schedule B-14; and

Debt: Sum of Rows 420 (Total Long-Term Debt), 4020 (Notes Payable), 4050 (Current Maturities-Long-Term Debt), and 4060 (Current Maturities-Capital Leases); less the amount in Row 1407 (Unamortized Debt Issuance Expense).

This approach can be readily followed for each exchange carrier and then compiled into a composite. The data for each exchange carrier can fit on a single row. The entire composite calculation for the BOCs can fit on a single page. The Commission should have sufficient familiarity with this option at this time that it can finally endorse its use. Based on a preliminary analysis, the resulting capital structure will not be meaningfully different than what obtains under the burdensome and time-consuming requirements that still prevail.

**2. Cost of Debt.**

The five cost of debt methodologies proposed by the Commission roughly correspond to the Commission-proposed capital structure methodologies.[120] USTA has a similar view as to these options. The holding company composite data should be rejected for the same reasons, while the composite BOC alternative should be utilized for the same reasons.[121] The proposed "general cost of corporate debt" methodology corresponds to the "conclusive" capital structure option and should likewise be rejected.

There should be no requirement to show each debt issue separately.[122] Such a requirement is burdensome, has no real regulatory purpose, and adds no accuracy to the calculation.

The Form M cost of debt approach requires the use of the following Form M data in addition to the capital structure debt component data listed above: Schedule I-1, Rows 7510, 7520, and 7530, and Schedule B-1, Rows 4260 and 4270. Additionally, a cost of short-term debt proxy is required. Federal Reserve Statistical Release G.13 shows a six-month commercial paper rate that is an adequate proxy for the cost of short-term debt, and this should be utilized.

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[120] Notice at ¶ 77.

[121] See discussion above at pp. 57-62.

[122] Notice at ¶ 79.

The average cost of debt for the calendar year would be determined with a numerator and denominator. The denominator would be identical to the debt component of the capital structure taken at the beginning and end of the year. The numerator would be determined as follows:

> Sum of Rows 7510 (Interest on Funded Debt), 7520 (Interest Expense - Capital Leases), 7530 (Amortization of Debt Issuance Expense), the approximate cost of Row 4020 (Notes Payable), the approximate cost of Row 4260 (Advances from Affiliated Companies), and the approximate cost of Row 4270 (Other Long-Term Debt).
>
> The cost of Rows 4020 and 4260 would be approximated by the sum of these two rows multiplied by the Federal Reserve 6-month commercial paper cost rate. The cost of Row 4270 would be approximated by the average cost rate of the other long-term debt rows. Mathematically, the cost of Row 4270 can be calculated as follows: Rows (7510+7520+7530) divided by the average of Rows (420+4050+4060-4260-4270-1407).

The use of the interest method of calculating the cost of debt should be acceptable to the Commission. The interest method conforms with the Uniform System of Accounts since January 1, 1988, is incorporated already into the Form M data, and is thus captured by the Form M approach now. Although it is important that the amortization of debt discount and issuance expense be factored into the cost of debt, it may be relatively unimportant whether the interest method or straight line amortization is used.[123]

Under the Form M approach, the Commission need not identify the general cost of corporate long-term and short-term debt. If

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[123] The Commission need not state an explicit method. Under the Form M approach articulated here, each debt issue is not shown separately. By adopting the Form M approach, the Commission would implicitly adopt the interest method.